Audit's NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

Monday, June 12, 1972 VOL. III, No. 11

TRUST SHARES FOR YOUR ATTENTION

INDUSTRY TRENDS

HUD'S CONSTRUCTION LOAN SURVEY GIVES REITS MAJOR SHARE OF MARKET

Mortgage trusts have been drawn into the HUD's monthly analysis of mortgage flows, a survey begun a year ago (see RTR, Apr. 10). HUD says the trusts held some $6.3 billion of mortgage loans in January 1972, with about 60% (or $3.8 billion) in short-term construction loans, 21% (or $1.3 billion) in long-term loans and 19% (or $1.2 billion) in land loans. The data cover about 95 operating mortgage trusts. The HUD survey now covers all major lenders except mortgage bankers. The HUD tally confirms our observations that REITs have established themselves with a major toehold in construction lending, their commitment volume in January and February nearly equalling that of the savings and loan associations. Here are some summary data from the first two months of this year (in millions):

	------Commitments-------			--Const. loans acquired--			-Land loans acquired-		
	Jan.	Feb.	Total	Jan.	Feb.	Total	Jan.	Feb.	Total
Banks	$2,602	$1,379	$3,981	$2,172	$1,403	$3,575	$365	$183	$548
S&Ls	668	750	1,418	691	703	1,394	58	72	130
REITs	670	685	1,355	316	359	675	93	93	186
TOTAL*	$4,111	$3,092	$7,203	$3,315	$2,596	$5,911	$531	$361	$892

* Includes other lenders, not shown separately.

During the two months, the trusts accounted for 18.8% of construction loan commitments, 11.4% of construction loan acquisitions and 21.5% of land loan acquisitions. At the end of February the trusts held $6.755 billion of construction loan commitments outstanding, or 26% of the $26.0 billion of commitments outstanding then.

A number of subscribers commented about poor quality of the reproduction of our computerized data in the last market and statistical issue of RTR. Problem is simply that a new teleprinter we are using didn't produce data of printing quality. Problem is being overcome with new equipment and next issue will be clearer.

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PUBLISHED TWICE MONTHLY ON THE SECOND AND FOURTH FRIDAYS SUBSCRIPTION $84 ANNUALLY GROUP RATES ON REQUEST

LONG TERM TRUSTS HAVE HIDDEN APPEAL BECAUSE LEVERAGING ABILITY IS UNSEEN

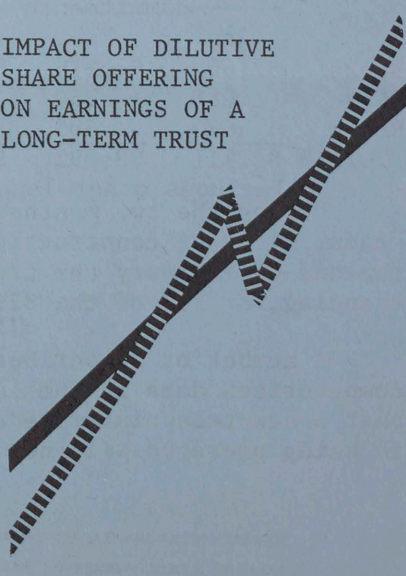
As a group, the long-term mortgage trusts have turned in some of the most sluggish performance records over the past two years. More than anything else this is because a goodly number of sophisticated money men have decided that the long-term trusts can't leverage themselves. No leverage, they reason, no growth.

On the theory that one man's poison may be another man's meat, we think it is time to take a hard look at the assumptions underlying the "no leverage, no growth" story. The reasoning goes like this: a good long-term portfolio of insurance quality probably can produce yields of 8½%-9% now; with book value of about 90% of original offering price (after sales commissions), that means the long-term trust would gross about 7.7%-8.1% on invested assets, and after about 1.5% for expenses and management fees, the trusts would pay only about 6.2% to 6.6% to shareholders. Since at least this yield is required in the market place for the best of long-term trusts (and is nearly 1% below the yield on new AA-rated utility bonds), shares of the long-term trust could never sell much above book value and thus would never be able to sell new shares at a premium above book value, which is the heart of equity leveraging.

There's a corollary which says that as a result long-term trusts will never be able to sell new shares without accepting some dilution to current earnings. This means that even when the long-term trusts leverage themselves with short-term debt, the dividend yield required on new shares (a cost of capital to the trust) will always be higher. In today's market, for instance, the cost of short-term debt is effectively 6% while only three long-term trusts, Connecticut General (6.2%), Mass-Mutual, (6.3%) and Northwestern Mutual (6.5%) have dividend yields in this range. Without these advantages, it is probable that earnings and dividends for long-term trusts will follow a zig-zag pattern generally upward instead of an unbroken upward line as shown schematically at right. In effect the trust over-leverages prior to a financing. And while earnings and dividends on a per-share basis may be disjointed, the market normally looks at the longer term.

But take a hard look at what the "long-term trusts" are really doing. Instead of building static insurance-type portfolios, most are following a hybrid investment strategy which gives them more leveraging opportunities than the assumptions above indicate. That strategy simply means that shareholders' equity will be invested in long-term mortgages or equities and short-term borrowings added to permit the trust to play the short-term construction market, where trust managers believe they can net 2%-3% spreads after expenses and interest whichever way the money winds blow.

IMPACT OF DILUTIVE SHARE OFFERING ON EARNINGS OF A LONG-TERM TRUST



So far, so good. Under that strategy the trust is using classic debt leverage to improve total yield. For a typical trust with an insurance-company type portfolio, income might be derived like this, at various levels of borrowing:

	1-1 leverage	2-1 leverage
Yield on equity	7%	7%
Yield on borrowings	2½%	5%
TOTAL RETURN	9½%	12%

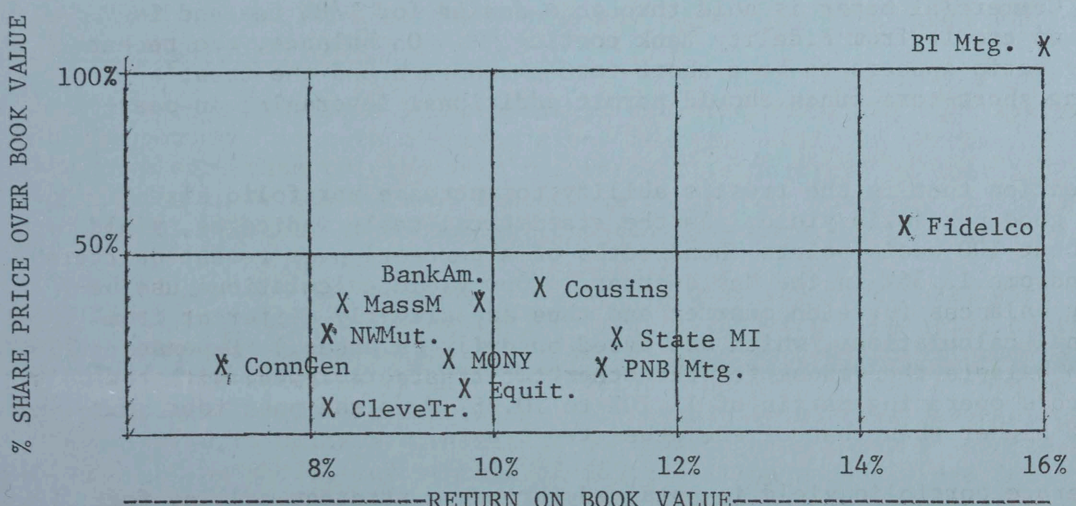
If shareholders continue to demand dividend returns of 6½%-7% for shares with this higher yield, then the shares above returning 9½% on book value would sell from 35% to 45% above book value while the

12%-returning shares would sell at from 72% to 85% above book value. But this seldom happens quite that easily, because the market discounts the risk in the additional leverage by demanding a higher yield on the shares. The shares still will sell above book value, though, and thus provide additional leveraging capability.

But then consider the next level of adaptation: the high-yielding long-term portfolio. Instead of a straight long-term portfolio of insurance-company texture, assume a portfolio of leasebacks, intermediate-term (over five years) mortgages and some equity investments yielding 11%-11½%. Fees will be higher, about 2%, probably. But net to shareholders without any leverage will be 9%-9½%, enough so that the shares command a modest premium over book value. Successive levels of leverage then increase return on book value sharply, assuming a 2% net spread on borrowings, as follows:

	1-1 leverage	2-1 leverage
Yields on equity	9½%	9½%
Yield on borrowings	2%	4%
TOTAL RETURN	11%	13½%

Are such yields possible? Demonstrably so, for our latest edition of Comparative Trust Statistics shows two trusts, *BT Mortgage* and *Fidelco Growth Investors*, with yields of 16.0% and 14.6% on book value respectively. And shares of these two trusts command the highest price over book value in the entire long-term mortgage group. This relation is shown graphically, comparing these two trusts with 10 other long-term trusts.



It all boils down to this: don't be fooled by categorization of a trust as "long-term." The trust with a traditional insurance-type mortgage portfolio has moderate leveraging ability because it can also tap the short-term construction loan market through short-term borrowings. And since the trusts building this type of portfolio are generally sponsored by large insurance companies or commercial banks, they can easily raise the funds they want for borrowing.

The more aggressive long-term trusts are going after long-term investment with yields 2%-3% above those of the insurance-type portfolios. More and more "long-term" in their parlance means a flexible, medium-term type financing--at or near 100% of appraised value over a builder's sweat equity--that brings home yields well above

those of the insurance-type portfolios. Often there is some income participation or other equity kickers, even in today's market. Both types of trusts are suitable for investors, providing the distinctions are recognized. The insurance-type trusts have stable income streams and moderate leveraging potential that suit them for longer-term investors. The more aggressive long-term trusts are suitable for investors looking for somewhat higher current income plus capital gains potential. Three trusts are reviewed below; others will be reviewed later.

Fidelco Growth Investors moved its leveraging ratio up sharply over the last four quarters after a relatively slow start following its initial public offering in August 1970. For the first three quarters after that offering, through May 1971, trust invested assets remained in the $21-$22 million range, largely reflecting rollover of initial assets. After that, fundings and commitment levels began rising sharply and had doubled by the end of February to $43.6 million. Portfolio rose another $3.6 million in the May quarter.

Portfolio growth was financed initially via bank borrowings and commercial paper, the trust's leverage ratio reaching slightly over 1-to-1 at the end of February when borrowings were $24.3 million over $22.45 million equity. But in early May the trust sold an additional 300,000 shares at $34.75 ($10.4 million gross proceeds). The replacement of short-term borrowings with equity cut the debt-equity ratio to 0.4-1 on $14.1 million borrowings on $34.2 million equity at May 31.

The trust's relations with the sponsoring Fidelity Corp. of Pennsylvania and its Fidelity Bank of Philadelphia have enabled the trust to obtain short-term funds at attractive rates. In the February quarter the rate was a thin 4.8% direct interest cost, among the industry's lowest, and this was little changed at 4.89% in the May quarter. Commercial paper is sold through a dealer for 1/8% fee and is backed by letters of credit from Fidelity Bank costing ½%. On balance, the recent drop of leveraging ratio appears to be a short-term phenomenon and the trust's strength in raising short-term funds should permit additional leveraging in near-term quarters.

The basic question then is the trust's ability to increase portfolio size while maintaining good portfolio yield. As the statistical table indicates, yield has declined by about 100 basis points (hundredths of a percent) over recent quarters but is still a handsome 12.36% in the May quarter. (Our yield calculations use beginning and ending balances for each quarter and thus are slightly different from the trust's internal calculations, which are based on daily balances.) Expenses have been lower on balance than those for the other two trusts reviewed, with the result that Fidelco's operating margin of 11.10% to 10.36% over the past four quarters is nearly 1½% higher than that of the other two trusts.

The above-average portfolio yield is obtained through a strategy calling for long-term investments in relatively specialized situations where extra yield is obtained as compensation for trust management's counseling and structuring work. At Feb. 29, long-term investments of $22.7 million were divided $8.8 million (or 38.9%) in first mortgage loans, $6.1 million (27.1%) in wrap-around loans, $5.6 million (or 24.%) in purchase and leaseback situations and the remainder in long-term development and junior mortgage loans.

Trust management is not making specific forecasts but has said that growth in invested assets to about $128 million by the November 1973 quarter would be required for the trust to earn $4.00 on the higher number of shares (1,340,000) outstanding after the May offering. Exercise of the 375,000 remaining warrants (at $25 per share) may be a moderating influence on share earnings and dividends. We estimate that it may well be the February, 1973 quarter before earnings and dividends reach the levels of the February quarter. These estimates indicate earnings and dividends

STATISTICS ON THREE LONG-TERM TRUSTS IN A COMPETITIVE MARKET

Quar.	Invest. (Mil.$)	----% of Avg. Investments---- Port. Yield(%)	All Expen.	Operating Margin	Indic. Money Cost	Spread on Debt*	--Per share-- Earn.	Div.
			Fidelco Growth Inv.					
Aug. 71	$ 30.18	13.16%	2.06%	11.10%	4.56	6.54	0.72	0.72
Nov. 71	39.11	13.33	2.23	11.10	5.95	5.95	0.82	0.82
Feb. 72	43.58	12.19	1.83	10.36	4.85	5.51	0.85	0.85
May 72	47.22	12.36	1.74	10.62	4.89	5.73	0.89a	0.70
			Equitable Life Mtg.					
July 71	125.96	10.52	2.12	8.40	--	--	0.46	0.42
Oct. 71	172.59	10.20	2.36	7.84	3.10	4.74	0.51	0.44
Jan. 72	183.34	10.16	1.88	8.28	4.05	4.23	0.60	0.46b
Apr. 72	194.05	9.94	2.02	7.92	3.95	3.97	0.58	0.48
			BT Mortgage Inv.					
June 71	47.71	11.27	2.56	8.71	4.32	4.39	0.40	0.40
Sept.71	59.25	12.00	2.65	9.35	5.44	3.91	0.47	0.425
Dec. 71	74.18	11.58	2.26	9.32	5.53	3.79	0.50	0.425
Mar. 72	89.53	11.16	2.33	8.83	5.25	3.58	0.55	0.48

a-Average shares. b-Plus $0.05 extra *Operating margin minus indicated money costs.

of about $0.78-80, $0.80-83, and $0.87-89 for the three quarters through next February. After that share earnings should show some further progress as re-leveraging takes effect, at 34 3/4(ASE) the shares may experience some near-term price weakness but have longer-term value.

BT Mortgage Investors is established as being among the most aggressive of the bank-sponsored long-term -rusts since it came public in October 1970. Invested assets have more than tripled over the first five quarters of operation, soaring from $39.3 million in December 1970, end of the first full quarter, to $89.5 million at the end of March. Further gains are anticipated for near-term quarters.

Portfolio yield has been well maintained over the past year, with March quarter yields of 11.16% down only slightly from the 11.58% from the prior quarter and the 11.40% of the year-earlier quarter. Part of this success in maintaining yields is attributed to the trust's ability to develop financing packages covering land purchase, construction and permanent financing. BT is able to do this because, unlike many other trusts, it aims to build a diversified portfolio balancing both short- and long-term holdings. At March 31, investments of $89.5 million were divided $43.8 million (or 48.9%) in construction loans, $15.6 million (or 17.5%) in intermediate-term mortgages, $20.7 million (or 23.1%) in long-term mortgages and $9.2 million (10.2%) in development loans. The trust hopes to be active in second mortgages some time later, and has not made any wrap-around loans or purchased equities.

BT's strategy, like other long-term trusts, aims at using proceeds from short-term borrowings to fund short-term construction and development loans. As a result of aggressive borrowing, BT's debt/capital funds ratio was 2.32-to-1 on March 31, based on borrowings of $62.32 million over $26.9 million of shareholders' equity and convertibles. Borrowings include $44.97 million of commercial paper and $17.35 million (net of discount) of 5 3/4% Series A subordinated debentures. These debentures, sold in January 1972, carried a 10-year term and achieved their extremely low coupon by attachment of 600,000 warrants to buy shares at $24 through January 1977. The heavy warrant attachment of 30 warrants per $1,000 debenture resulted in $2.7 million of

original issue discount, which is a non-cash charge that penalizes earnings by about $0.035 per share quarterly.

But the financing was regarded in the industry as among the most sophisticated yet devised, and as a result earnings and dividends have not paused in the zig-zag pattern described on page 2. Part of this is due to the fact that BT is sponsored by Bankers Trust New York Corp., one of the nation's largest commercial banks. BT is advised by Sackman-Gilliland Corp., a large mortgage banker acquired by BT in September 1969.

The trust has compiled an impressive record, with the portfolio growth and sustained yield fueling a rise in share prices from an offering of 12½ (adjusted for a subsequent 2-for-1 split) to current quotes about 29 3/4 (ASE). At today's quotes it is richly appraised relative to the group at a 14.3 P/E ratio and a 6.5% dividend yield. <u>At these levels the shares have some risk but may be held in more aggressive accounts.</u>

Equitable Life Mortgage and Realty Investors (30 3/8-NYSE) is an offshoot of Equitable Life Assurance, the third largest insurance company. As such an affiliation would imply, certain conservative strengths and characteristics prevail in the trust. On top of the list is the vast organizational support that provides important services and financial tie-ins. The 35 field offices each staffed with two to seven men provide as wide national real estate coverage in every major market as anyone can muster. Having its own staff of standing experience means close, directly responsible monitoring of projects with one of the excellent records of foreclosure experience. Borrowers are concomitantly of high quality.

Beyond direct real estate staffing, the ability to package offers high assurance of continuing placement levels. For example, in today's difficult construction loan market, the trust has not sacrificed quality because it obtains the better construction loans by packaging them with the permanent financing. It either ties in with the insurance company or banks. Parenthetically, the <u>parent is one of the most active long-term lenders today believing long rates will not rise much if at all.</u> One service benefit is development of a computer program for the trust which gives complete portfolio, balance sheet and profit & loss breakdowns and projections based on history or any given assumptions. One of the most advanced such computerized techniques that may be available to any trust, eventual significance may be a more formalized basis for asset and liability decisions. This level of computerization would not have been possible without the parent's staff.

The trust is now lined up long term. Beyond the $129 million funded, it has $63 million committed and will be at about $170 million funded by year end. This will more than equal the $145 million equity base and still represents a sound ratio. The ratio could be quickly contracted by run-offs or even equity financing but more realistically, the intermediate nature of some of the long-term portfolio makes the relationship very safe. Relatively small equity additions are still being made. Some joint ventures and some subordinated land deals are being worked on. Equity fundings were about $8 million.

The activity and placements are in the short-term category in which $57 million was invested on April 30. Stiff run-offs may prevent this level from rising much the next quarter or two despite the $61 million committed. The level should rise, however, over time with consistent profitability (at floating rates) and continued high quality. Several large construction loans are being worked on which could notably increase short commitments and we think there is a fair chance of this category almost doubling to over $100 million by the end of 1973. The addition will be pure leverage on the liability side since the trust can go 2-1 meaning $300 million short. The commercial paper is naturally prime rated and comes out of Goldman Sachs.

The nature of the trust's philosophy shows up in the portfolio makeup and the internal statistics. The property mix is: 25% shopping centers, 22% apartments, 19% office buildings, 10% industrial properties, 8% department stores, 5% hotels and 10% other. Yields are low in keeping with the conservative lending to prime borrowers. On the other hand, borrowing costs are also low. Margins have narrowed in recent quarters but should at least stabilize this quarter. Overall profits should certainly pickup in the second half with annualized profitability running at over $2.30 per share, diluted by year-end. The shares are a conservative, fairly valued holding.

SUITS ARE BEGINNING TO CROP UP IN THE INDUSTRY, IMPACT SEEN LIMITED

A suit was recently filed against Chase Manhattan Bank claiming its sponsorship of the Chase Manhattan Mortgage and Realty Trust violates the Banking Act of 1933, which separated commercial banking from the securities business. The suit seems based on two issues: a trust is an indirect way of entering the security business and the bank by virtue of its relation to the trust, controls the trust. The former is stretching a point in equating mortgage to securities. Alleged control of the trust by the bank is also a weak contention as the relationship is contractual at discretion of the trust and outside directors control majority voting power with ability to approve loans. It is not naive to assume the bank wishes to keep its relationship above board; a lucrative advisory fee is obtained.

Knowledgeable legal observers do not consider the above action particularly troublesome. Rather the ominous aspect is that the industry probably faces a growing number of suits. The industry is large with novel, untested relationships. Hence shareholder suits will be attracted. The suit contesting sale of Jim Harper's advisory company to Continental Illinois Corp. is already well known.

Another sign of the times is the suit instituted a few months ago essentially against the management and trustees of Continental Mortgage for forming Diversified Mortgage in 1969. This derivative action brought on behalf of Continental shareholders alleges that CMI's management, by forming Diversified, diverted investment opportunities away to the new trust. Management feels the suit is without merit, the obvious logic being the two trusts make loans of different maturities on different types of property. Shareholders of CMI need not be directly concerned. They would be the nominal beneficiaries. Damages are being asked of the trustees and management. No absolute legal judgments can be made now. It is apparent, however, the industry is open to legal harassment on the matter of sister trusts. (We pointed out in the May 15 issue that sister trusts were proliferating.) The situation is somewhat analogous to mutual fund managements which form new funds for different investment goals. While not questioning totally the rationale for sister trusts, they do leave advisers open to conflict of interest suits.

TRUST NOTES: FIDELITY' MORTGAGE'S DIVIDEND REINVESTMENT PLAN; NEW PRIVATE TRUST

Fidelity Mortgage Investors has started to offer a dividend reinvestment plan that differs sharply from the industry's two other such plans. Fidelity's plan, worked out in cooperation with First National City Bank of New York, departs from the others by letting shareholders purchase additional shares in the market. Thus while the trust shares gain some market support, the trust itself receives no new money.

The other two plans, offered by *Cousins Mortgage* and *PNB Mortgage & Realty*, channel new money back to the trusts by letting shareholders buy new shares from the trust at discount prices. The new shares are sold to participating shareholders at the lower of book value or market price, a formula which means the trust could be selling new shares below book value if the stock price falls below this point.

The Fidelity plan in effect passes on the volume savings of block purchases to participating shareholders. Dividends due to participating shareholders are sent to First National City Bank, which acts as agent to purchase as many shares as possible at current market. If a shareholder's dividend is not large enough to buy a full share, the shareholder is credited with a fractional share to three decimal points. The shares are held by the bank, unless otherwise specified, and quarterly statements are rendered. Upon termination, certificates for full shares are issued and fractional shares converted to cash. The bank's service charge is 5% of the amount reinvested to a maximum $2.50 per transaction, plus a pro rata share of commissions. After the first reinvestment, shareholders may add additional amounts to their purchase for the maximum $2.50 fee. Citibank administers similar plans for many industrial companies and finds that about 10% of a typical shareholder list will choose to participate.

Realty Growth Investors has begun operations as the industry's newest private trust. Completion of a 270,000 share private placement at $100, plus purchase of 45,000 shares by sponsors, let the trust start life with capital of about $31.4 million. About $14.6 million was taken down immediately and the remainder will be taken down in about nine months. Paine, Webber, Jackson & Curtis handled the placement. Initial investments are in short-term construction and development loans but the trust expects to emphasize long-term mortgage and equity investments. The trust is advised by newly formed Mortgage and Equity Consultants, Inc., owned jointly by Equitable Trust Co. of Baltimore and Mathews-Phillips, Inc., a Pittsburgh apartment development and construction company. Mathews-Phillips in turn is 49% owned by Gulf Oil Co. H. Grant Hathaway, Equitable's executive vice president, serves as chairman of the trust and president of the adviser; Howard E. Phillips, executive vice president of M-H, is president of the trust and executive vice president of the adviser. Ronald Depew is vice president and treasurer of the adviser. Address: Munsey Building, Calvert & Fayette Streets, Baltimore, Md. 21202. Phone: 301/727-2222.

READERS REASSURED ON BALLOONING RISK

Lest some readers imply from our January 17 RTR that ballooning incurred significantly more risk than straight loan amortization, let us put it in perspective. Economic viability of the property is always the major credit determinant. Ballooning a loan is only a marginal factor with the lender's added risk being he might not recover his principal within the shorter period. If not, the loan, already partially reduced, could be extended. Naturally, an amortizing debt instrument is higher grade, other things being equal. The Federal Home Loan Bank Board has just approved ballooning for the S&Ls.

DEFECTIONS OF CHARTER STAFF RAISED QUESTIONS FOR GUARDIAN MORTGAGE

It was known in late March that James Winston left *Guardian Mortgage's* parent, Charter Co. where he was Executive VP. His position was in realty development. Word subsequently came out that part of the loan production staff followed him. Since Guardian Mortgage has come to rely more on its parent for originations, see RTR, May 15, this was a matter of some concern. Official breakdown from the adviser is that twelve men in all left: Winston, four from the Jacksonville office doing loan origination, four from Charter Properties (now dissolved) and three from realty development. The four in loan origination were replaced. The others do not pertain to the trust. Back at the trust, the loan flow continues to look healthy. Commitments in the May quarter exceeded the $72 million goal by 4%. Closed loans at May 31 stand at $364 million, funded commitments at $168 million. Commitments of $100 million have yet to be closed and $85 million are in pipeline (being worked on). Cash fundings by yearend, Feb. 1973 should be $270 million. The underlying fundamental picture does not seem to have changed much but a temporary cloud has been hung over the shares.

Written as of noon Thursday, June 8.